BEFORE
THE PUBLIC SERVICE COMMISSION OF
SOUTH CAROLINA

DOCKET NO. 2018-318-E

In the Matter of:	)	
	)	**DIRECT TESTIMONY OF**
Application of Duke Energy Progress, LLC	)	**JOHN PANIZZA**
For Adjustment in Electric Rate Schedules and	)	**FOR DUKE ENERGY**
Tariffs	)	**PROGRESS, LLC**

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS, AND POSITION WITH DUKE ENERGY CORPORATION.

A. My name is John Panizza, and my business address is 550 South Tryon Street, Charlotte, North Carolina. I am employed by Duke Energy Business Services LLC ("DEBS") as Director Tax Operations. DEBS provides various administrative and other services to Duke Energy Progress, LLC ("DE Progress" or the Company) and other affiliated companies of Duke Energy Corporation ("Duke Energy").

Q. PLEASE SUMMARIZE YOUR EDUCATION AND PROFESSIONAL QUALIFICATIONS.

A. I have a Bachelor of Science degree in Accounting from Montclair State University and a Master's in Taxation from Seton Hall University. I am a Certified Public Accountant in the state of New Jersey. My professional work experience began in 1989 as an auditor with KPMG. From 1993 to 2002, I held a number of financial positions primarily at two companies, in telecommunications and automotive (AT&T Corp., and Collins & Aikman Inc.). In 2002, I joined Duke Energy and have held a number of financial positions of increasing responsibilities, including various accounting and tax related positions. In March 2018, after a three year rotation primarily in Corporate Accounting, I moved back into the role of Director, Tax Operations, a position that I had previously held.

Q. PLEASE DESCRIBE YOUR DUTIES AS DIRECTOR TAX OPERATIONS.

A. As Director Tax Operations, I have overall responsibility for corporate tax compliance and accounting for Duke Energy. The Duke Energy Tax Operations Department is responsible for all federal, state, and local income tax returns for Duke Energy including various joint ventures if Duke Energy is the designated tax matters partner. The Tax Department is responsible for maintaining and reconciling Duke Energy's tax accounts and for the reporting and disclosure of tax-related matters, to the extent required.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THIS COMMISSION OR OTHER STATE PUBLIC UTILITY COMMISSIONS?

A. I have not testified before this Commission, but I have filed testimony on behalf of Duke Energy in proceedings before the Indiana and Kentucky utility commissions.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A I address the recently enacted federal tax reform legislation, the Tax Cuts and Jobs Act (the "Tax Act"), which became law on December 22, 2017.

Q. PLEASE PROVIDE AN OVERVIEW OF YOUR TESTIMONY.

A. While the headline change brought by the Tax Act is a reduction of the statutory corporate tax rate from 35 to 21 percent, this reduction in rate is accompanied by many other provisions. The varying impacts of the Tax Act on the revenue requirement all must be taken into account, as the Company has done in its proposal for how best to address the TCJA for the benefit of customers in South Carolina. Customers should – and will through the Company's proposal in this case – benefit from the overall reduction in the revenue requirement, but it is appropriate to also consider other, non-tax impacts of the legislation, particularly as it relates to cash flow. This need was highlighted by Moody's Investors Service ("Moody's) in an article it published on January 24, 2018,[1] approximately a month after the Tax Act became law which highlights the Tax Act effect of putting pressure on cash flow and the possibility of an overall negative credit impact on utilities. This was, of course, an industry-wide analysis where some issuers will be affected by a greater amount, some by a lesser amount. However, I wish to highlight in my testimony that the implementation of the Tax Act has the potential to adversely affect the Company's cash flows and credit metrics. These negative impacts must be taken into account and makes having a strong equity to debt capital structure even more important post-Tax Act reform.

Further detail concerning the credit quality impact of the Tax Act is provided in the pre-filed direct testimony of witness Sullivan, and additional details on the effect of the Tax Act on revenue requirements are included in the testimony of Witness Bateman. The Company's plan to incorporate the benefits of the Tax Act for the benefit of customers is balanced, appropriate,

[1] Moody's Investors Service, Sector Comment, "Tax Reform is Credit Negative for Sector, but Impact Varies by Company," January 24, 2018. This article notes (at p. 2) that "For the investor-owned utilities sector, the 2017 tax reform legislation will have an overall negative credit impact on operating companies and their holding companies." Moody's estimates that the Tax Act "will dilute a utility's ratio of cash flow before changes in working capital to debt [FFO/Debt] by approximately 150-250 basis points on average, depending to some degree on the size of the company's capital program."

and consistent with the Commission's direction to defer tax benefits and incorporate unto DE Progress's next rate case.

II. <u>TAX REFORM</u>

Q. WHAT ARE THE KEY PROVISIONS OF THE TAX ACT AS IT RELATES TO DE PROGRESS?

A. Most changes to the corporate tax code apply to all U.S. corporations equally; while a limited set of others affect regulated utilities uniquely. For utilities in general, and DE Progress in particular, the key provisions of the Tax Act that will affect customer rates are as follows: (1) reduction of the corporate tax rate from 35 percent to 21 percent; (2) retention of net interest expense deductibility; (3) elimination of bonus depreciation; (4) elimination of the manufacturing deduction; and (5) normalization of excess accumulated deferred income taxes (ADITs) resulting from the Tax Act.

Q. PLEASE SUMMARIZE HOW THESE KEY PROVISIONS IMPACT DE PROGRESS AND CUSTOMER RATES.

A. <u>REDUCTION IN CORPORATE TAX RATE</u>: The new statutory income tax rate of 21 percent represents a 40 percent reduction from the previous rate of 35 percent. This will lower a key component of cost of service, i.e., income taxes. In contrast to this lower cost of service impact, however, rate base will be higher in future rate proceedings due to the elimination of bonus depreciation (see below) and the reduced value of accelerated depreciation due to the lower federal income tax rate.

<u>INTEREST EXPENSE DEDUCTIBILITY</u>: The Tax Act generally provides that net interest expense is deductible only to the extent it does not exceed a stated percentage of an adjusted taxable income calculation, a calculation that becomes even more restrictive four years hence. However, regulated utilities are exempt from this limitation provision and may deduct their interest expense without limitation. Duke Energy and EEI (the regulated electric utility trade association) fought hard to achieve this important exemption, and our customers will retain the significant benefits that flow from it.

<u>DEPRECIATION AND EXPENSING OF CAPITAL</u>: The Tax Act generally provides that corporations may immediately expense capital as it is placed in service, akin to 100 percent bonus depreciation. However, the Tax Act specifically prohibits the immediate expensing of capital by regulated utilities. Instead, utilities are directed to use MACRS (modified accelerated cost recovery system) depreciation for capital investment placed in service. Though no longer accompanied by "bonus" depreciation, MACRS still represents a significantly accelerated rate of depreciation compared to book depreciation. As a result, deferred taxes will continue to accrue under MACRS, but will do so at a slower rate compared to bonus depreciation and at a much slower rate under the lower 21 percent corporate tax rate (see above)—this will cause a more rapid increase to rate base relative to pre-Tax Act.

<u>MANUFACTURING DEDUCTION</u>: Prior to the Tax Act, domestic manufacturers were granted a tax deduction based on a certain percentage of

qualifying manufacturing income, and the production of electricity qualified for this tax benefit. In order to avail itself of this deduction, a corporation had to be in a taxable income position—this was often not the case recently for most regulated utilities because of the impact of bonus depreciation. Unfortunately, the elimination of bonus depreciation for utilities in the Tax Act coincided with the elimination of this tax deduction for all manufacturers, which is directionally detrimental to customer rates.

EXCESS DEFERRED INCOME TAXES: At the end of 2017, DE Progress has a significant net deferred tax liability, booked at a 35 percent corporate tax rate and driven overwhelmingly by accelerated and bonus depreciation of fixed assets for tax purposes. Because a deferred tax liability represents taxes collected from customers but not yet paid to taxing authorities, and because the ultimate payment of these taxes will now occur at a 21 percent corporate tax rate (down from 35 percent), the balance of deferred tax liability must be remeasured. The resulting "excess" deferred tax balance becomes a regulatory liability. The Tax Act requires that excess deferred taxes generally associated with property, and specifically connected to the accelerated depreciation of property, must be normalized into customers rates in a highly-prescribed manner that mimics the remaining life of the underlying assets. These are known as "protected" excess deferred taxes. All other excess deferred taxes may be treated by the commission like any other regulatory liability in the rate-setting process.

Q. PLEASE DISCUSS THE CONCEPT OF BONUS DEPRECIATION.

A. Bonus depreciation is an enhanced form of accelerated depreciation for tax purposes. Congress has used bonus depreciation for well over a decade to encourage capital investment, at varying times renewing the provision just as it is set to expire and modifying the degree to which depreciation in the first year (the "bonus") could be claimed. Prior to the Tax Act, existing bonus depreciation laws were scheduled to sunset in 2020, but could very well have been extended as in years past. In 2017, prior to the Tax Act, bonus depreciation was 50 percent—this means that corporate taxpayers could depreciate 50 percent of capital placed in service in the first year *in addition to* a normal level of tax depreciation (MACRS) on the remaining 50 percent.

Bonus depreciation has the effect, generally, of reducing taxable income, and therefore deferring associated cash taxes. However, utilities, being very capital-intensive businesses, were often put into tax loss positions (net operating losses, or NOLs) from an abundance of bonus depreciation and therefore were limited in their ability to incrementally delay cash taxes. To the extent that a utility could defer cash taxes due to bonus depreciation, however, a net deferred tax liability was established. The cash collected from customers but deferred from the taxing authorities was used to fund the operations and investments of the utility and avoided a commensurate level of third-party financings that would otherwise have been necessary but for the additional deferred income taxes.

Q. PLEASE DISCUSS THE CONCEPT OF ACCUMULATED DEFERRED INCOME TAXES ("ADIT")

A. Many timing differences exist between when income taxes are collected from customers in rates and when the Company pays those taxes in cash to the IRS. Sometimes the taxes are paid sooner than when they are collected from customers (which creates a deferred tax asset on the Company's books), and sometimes they are paid later (creating a deferred tax liability). Deferred taxes balances, therefore, result from book/tax timing differences between the recognition of income and expenses. All deferred tax balances, whether they are assets or liabilities, reverse over time and converge to zero over the life of the underlying item giving rise to the deferred tax balance.

To illustrate, see the table below. In this example, I assume the Company invests $1,000 in an asset with a useful life of ten years. Because the useful life is ten years, the initial cost of the asset will be spread out evenly over the ten-year period such that the depreciation expense for book purposes is $100 per year. Another assumption in this example is that the Company is allowed to accelerate the depreciation of the investment over a much shorter life for tax purposes—five years in my example (the IRS provides tables that are used to calculate the annual tax depreciation expense).

In this example, DE Progress is allowed to depreciate $200 of its investment for calculating its current year tax liability, but only $100 for calculating its book tax expense. Because of that difference, the Company's income taxes paid is $35 less (at the 35 percent tax rate) than it would have been using the useful life as the basis for calculating taxes. In the example below, it shows that by end of year six the Company will have fully depreciated its investment for tax purposes but is still recording depreciation expense for book purposes. The benefit to the Company and customers is apparent in the "accumulated" column. The figures in this column represent cash available to the Company from what amounts to a zero-cost loan from the government. This balance benefits customers by providing an offset to rate base.

Table 1					
	Depreciation Expense			**Deferred Tax**	
Year	**Per Books**	**Per Tax**	**Difference**	**Current Year**	**Accumulated**
1	$100	$200	$100	$35	$35
2	100	320	220	77	112
3	100	192	92	33	145
4	100	115	15	5	150
5	100	115	15	5	155
6	100	58	(42)	(15)	140
7	**100**	**-**	**(100)**	**(35)**	**105**
8	100	-	(100)	(35)	70
9	100	-	(100)	(35)	35
10	100	-	(100)	(35)	0
	$1,000	$1,000	$0	$0	$0

III. THE COMPANY'S PROPOSAL

Q. HOW DOES THE COMPANY'S APPLICATION IN THIS RATE CASE REFLECT THE IMPACTS OF THE TAX ACT?

A. Company Witness Bateman describes how the Company has incorporated into the base rate revenue requirements in this case the reduction in the corporate income tax rate from 35 to 21 percent. For the remaining benefits of the Tax Act, the Company is proposing to create an Excess Deferred Income Tax

("EDIT") Rider (the "EDIT Rider"). It is my understanding that the EDIT Rider contains the following five categories of benefits for customers:

1. Federal EDIT – Protected
2. Federal EDIT – Unprotected, PP&E related
3. Federal EDIT – Unprotected, non PP&E related
4. Deferred Revenue
5. NC EDIT

While Witness Bateman describes the structure and mechanics of the EDIT Rider, my testimony addresses the categories of federal EDIT that are included in the rider.

Q. PLEASE DESCRIBE THE THREE BUCKETS OF FEDERAL EDIT.

A. In order to understand the Company's proposal, it is necessary to understand the different types of assets from which EDIT is derived, and their differing treatment by the Tax Act. The $207.7 million of EDIT, as of the end of 2017, is in three different buckets. In one is approximately $165.0 million as of the end of 2017 of what is called "protected EDIT" – that is, EDIT related to the Company's investment in property, plant and equipment, whose flow back treatment is expressly made subject to IRS normalization rules by the Tax Act. The normalization rules – specifically, Section 13001(d)(3)(B) of the Tax Act – require protected EDIT to be flowed back over the remaining lives of the property giving rise to the deferred tax balance.

The remaining EDIT, totaling approximately $42.7 million, as of the end of 2017, is "unprotected" under IRS rules, and, therefore, subject to flow back in a timeframe open to discretionary action by the Commission. But this amount includes a liability totaling $47.8 million that relates to the Company's investment in property, plant, and equipment, and is the second bucket of EDIT. This portion of unprotected EDIT is not required to be normalized under the Tax Act. Although both buckets are property-related, the Internal Revenue Code protects one but not the other. However, the rationale for normalization applies to this portion of EDIT as much as it applies to protected EDIT, and so normalization at some level is appropriate. The assets represented in this bucket have an average life of approximately 25 years for DE Progress, although, as discussed below, the Company Proposal uses a shorter 20-year period over which to accomplish this flowback.

The third and final bucket is unprotected EDIT that is not related to the Company's investment in property, plant, and equipment. For DE Progress, this amount is an asset of $5.0 million. Again, these balances are as of the end of 2017. The Company has made and may make additional adjustments to these amounts in 2018, and will provide updated balances at the end of 2018 as discussed by Witness Bateman.

Q. WHAT IS THE FLOW BACK PERIOD FOR PROTECTED EDIT?

A. These amounts are generally related to Property, Plant & Equipment (PP&E), and there are specific IRS requirements that require that this amount be returned to customers no more quickly than the prescribed method. For protected EDIT, the Company applies the Tax Act-prescribed IRS normalization rules. The amortization period the Company is using here is called the Average Rate Assumption Method ("ARAM"). ARAM is the method under which the excess in the reserve for deferred taxes is reduced over the remaining lives of the property as used in its regulated books of account which gave rise to the reserve for deferred taxes. Under such method, during the time period in which the timing differences for the property reverse, the amount of the adjustment to the reserve for the deferred taxes is calculated by multiplying—(i) the ratio of the aggregate deferred taxes for the property to the aggregate timing differences for the property as of the beginning of the period in question, by (ii) the amount of the timing differences which reverse during such period.

Q. WHY IS THE COMPANY PROPOSING TO FLOW BACK THE CLASS OF UNPROTECTED PROPERTY-RELATED EDIT OVER 20 YEARS?

A. The 20-year period is appropriate because it is tied directly to the underlying assets that created the deferred tax balances which became EDIT when the Tax Act dropped the corporate tax rate to 21 percent. Protected and unprotected property related deferred taxes are no different except for the fact that they come from two places in the Internal Revenue Code and the statute protects one and it does not the other. The flowback of excess deferred taxes over the life of the underlying assets makes sense, as does normalization concept underlying the 20-year flowback proposal. Normalization, or the gradual return of EDIT over the life of the capital asset being depreciated, balances the customer and the Company's interests; it protects the Company's cash flow and also protects the customer against rate volatility, because the deferred balance acts as an offset to rate base, and, therefore, a reduction in rates.

Matching the flowback period to the timeframe over which flowback would have occurred absent the Tax Act is important in other ways. Deferred taxes represent an interest-free loan from the government. The Company then used these funds, at no cost to customers, to invest in its business. By doing so, the Company avoided having to go to the capital markets to raise this portion of the funds that it invested, and customers saved the capital cost of its being able to use the interest-free loan from the government instead of investor-supplied capital. But having invested in the business, there is not a readily available reserve pool from which the cash needed to flowback EDIT can be drawn. Flowback over the 20-year period that more closely matches the asset lives, smooths out the cash flow hit that the Company must take as it returns EDIT to customers and lessens the need for the Company to raise those funds from investors and third-parties.

Q. PLEASE SUMMARIZE HOW CUSTOMERS BENEFIT FROM THE CHANGES IN THE COMPANY'S COST TO SERVE AS A RESULT OF THE TAX ACT?

A. As this Commission is well aware, electric utilities are one of the most capital intensive industries in the country. The Company invests in infrastructure not because of federal tax policy, but because it is critical, necessary, and often legally required that it do so. The Company's privilege and obligation to serve customers requires the financial wherewithal to support operational commitments on a reliable and cost-effective basis. Credit quality drives access to affordable capital, and for this reason it is in the best interest of customers to prevent a weakening of the Company's cash flow and credit quality from pre-Tax Act levels.

The Company's proposal included in this case both provides immediate benefit from the Tax Act and continues benefitting customers through the return of deferred taxes over time, as explained by Witness Bateman. The Company's proposal further complies with accounting requirements while preserving the Company's credit rating by not creating undue pressure on cash flows.

Q. DOES THIS CONCLUDE YOUR PRE-FILED DIRECT TESTIMONY?

A. Yes.